GRIMES & COMPANY, INC.
A Registered Investment Advisor

Client Newsletter – Mid Quarter Update – November 2011

Much has occurred since the May mid-quarter update, when the markets were near their highs for the year. Since that peak the S&P 500 has dropped over 20% before putting in a low on August 4. From that point markets rallied over 10% and now stand near even year-to-date. As would be expected during such violent swings, volatility increased dramatically, with the VIX volatility index rising from a complacent reading of 15 in May to readings in the high 40's in August. Readings that high are rare and are usually associated with major events such as the September 11 terrorist attacks and the credit crisis of 2008. As of this writing the VIX remains at elevated levels in the mid-30's, suggesting an anxious market environment. Daily market fluctuations in the 2-3% range have become relatively common of late, since the market is having a difficult time balancing reasonably strong earnings and slightly improving economic statistics with grave concerns about Europe.

Economic growth picked up a bit in the third quarter, with a 2.5% initial GDP reading versus 1.3% in the second quarter and 0.4% in the first quarter. The unemployment situation remains rather stagnant, with a 9% unemployment rate and a modest 80,000 payroll additions. While the job market has stabilized, it is still quite weak for a recovery, averaging only 126,000 additions per month for 2011, compared to 200,000 to 300,000 seen in the 1994-1995 and 2004-2005 recoveries. Many of the manufacturing surveys, such as the ISM and the Regional Fed surveys, that were declining significantly in the late Summer/early Fall time frame have bounced back to more neutral levels, indicating that the economy at this point is not falling off a cliff but rather holding up modestly.

The European debt crisis continues in earnest. The October 26 meeting delivered some hope with a three prong attack for dealing with Greece, including a 50% reduction of Greek debt, new bank stress tests, and plans to lever the EFSF (the fund that will be used to inject capital to the banking system) from 440€billion to 1€trillion. Unfortunately, as has been the case with prior EU plans, working out the details has been slowed by political debate, leaving the markets again waiting on a solution. This was compounded by Prime Minister George Papandreou briefly contemplating putting Greek's continued European Membership to a popular vote. He ultimately stepped down in favor of a national unity government lead by technocrat Lucas Papademos, a former vice president of the European Central Bank, with a mandate to see through the necessary austerity legislation.

Policymaker dithering left the problem uncapped, and the market's focus shifted to the next potential domino: Italy. Yields on Italian government debt skyrocketed over 7%, the same level that led to bailouts of Ireland and Greece. Italy is much more important than Greece, as it is the third largest economy in Europe, and though they are considered "too big to fail", they may ultimately prove to be too big to save as well. Greece in isolation was never really a problem, as they only have about €350 billion of debt outstanding in total, which is easily covered by the unlevered deposits to the EFSF, and all of Greece's debt could be paid for in a day if need be. Trouble in Italy is much more severe, since they have nearly €2 trillion in outstanding debt. There is little doubt that an Italian debt crisis could trigger some sort of financial Armageddon in Europe that would impact global markets and leave a big scar for some time to come, potentially ending the European Union.

Finally, within a week of the Greek leadership crisis, the Italian Prime Minister Silvio Berlusconi also threatened a national election (which would have left a leadership vacuum for two to three months), before agreeing to step down in favor of a unity government lead by another well respected technocrat, former European Union Competition Commissioner Mario Monti.

A more important factor, and one that is little discussed on the news, is that as part of the "rescue" package for Greece, the European powers pressured the International Securities Derivative Association (ISDA) to not mandate a 50% write-down of Greek debt, favoring instead a "voluntary" debt restructuring. By doing so, the ISDA has effectively nullified the use of credit default swaps (CDS) on sovereign debt. In simplest terms, CDS is like buying an insurance policy on an underlying bond position. If the bonds default, the CDS makes you whole. Without the ability to hedge, banks and other market participants are not only unlikely to buy additional sovereign debt when these troubled countries need financing, but they are also likely to sell existing debt on their balance sheets, creating an unintended rise in interest rates and borrowing costs for troubled nations. This is just what happened with Italy, as their cost of borrowing doubled in less than a week. Unlike the Greek situation, default for Italy is not imminent as their existing debt maturities are much further out along the time line and a short term jump in their borrowing costs is manageable.

In the grand scheme of things, there is a reasonable likelihood that Europe will work through this mess, but this will lower economic growth for the global economy as a whole. The European Union has lowered their growth forecast for 2012 from 1.5% to 0.5%, and we would not be surprised to find out that growth is actually going to be negative and that Europe may very well be in a recession already. We believe that the US financial system has stabilized and will be able to weather a European banking crisis, but it is Europe's impact in the global economy that does concern us from the standpoint that lower growth in Europe could lead to lower growth in the emerging markets, which at this point is the only place offering meaningful economic growth. Should that occur, then it would become more likely that we could experience a recessionary event here as well.

Also looming on the horizon is the November 23 deadline for the twelve member Congressional supercommittee to arrive at long term solutions to our national debt and deficit situations. As these discussions remain behind closed doors we have no idea what they may release. However rumors suggest that the Republican opposition to raising taxes and the Democrats intransigence to cut spending persist. Unfortunately, both options are probably necessary to right the ship, and this will be the next dominant recurring story for the headlines

When we look at the investing environment we feel that stock valuations are attractive and fundamentals are sound, but the macroeconomic environment is holding us back from being more aggressive. From a bond perspective, high-quality bonds are expensive and yields are unattractive, but the macroeconomic environment dictates that exposures to safe investments are nonetheless still important and necessary in most client portfolios. We continue to remain cautious and defensive, and the coming months and quarters will be interesting as we continue along the delicate path of slow economic advance on one side and potential recessionary forces on the other. All eyes will be on Europe to see if they can contain this crisis before it becomes unmanageable.

Operational Issues

New Website and Logo – In the upcoming weeks we will be unveiling our completely redesigned website and updated logo. Stay tuned!

Fidelity Clients – We would like to make you aware of an upcoming change in the way you access your Fidelity accounts online. Because of changes in the way Fidelity supports our current interface, clients who access their Fidelity accounts through our website will be directed to Fidelity.com. The Fidelity site will give clients increased functionality and a better user experience. We will be sending more specific information to our Fidelity clients in the upcoming weeks via email, so please contact us if your email address has recently changed.

Emergency Email Domain – Our normal email domain is grimesco.com. Our back up email domain in case of power or other emergency issues is grimescompany.com. Please be sure that both of these are added to your safe senders list so you continue to receive emails from us without delay.

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Not a substitute for tax or legal advice. Sources include eSignal.com,Bureau of Economic Analysis, Bureau of Labor Statistics

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